

IN THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

DONALD G. OREN and BEVERLY J. OREN,

Petitioners-Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

ON APPEAL FROM THE DECISION
OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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SUMMARY OF THE CASE AND REQUEST FOR ORAL ARGUMENT

This federal income tax case involves an attempt by Donald G. Oren (taxpayer), by means of a series of circular “loan” arrangements, to increase his basis in two wholly-owned S corporations and his concomitant ability to deduct those corporations’ losses on his individual income tax returns. *See* IRC § 1366(d)(1). Upon the advice of his tax advisors, taxpayer purported to borrow monies from a third, profitable S corporation that he controlled and then “lent” those funds to the two loss-producing corporations, which immediately purported to lend the same amounts back to the profitable corporation. The Tax Court concluded, however, that these “loans,” although documented by notes, did not result in an actual economic outlay by taxpayer, but in substance amounted to no more than offsetting book entries. The court further determined that deductions were precluded in any event because taxpayer was not “at risk” under § 465 with respect to borrowed funds so advanced. The circularity of the arrangements, which eliminated any realistic possibility that the monies would not be repaid, amounted a stop-loss arrangement within the meaning of § 465(b)(4). Taxpayer now appeals.

Counsel for the Commissioner believe that oral argument of at least fifteen minutes per side would be helpful due to the complexity of the issues presented.

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No. 03-1448

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v.

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ON APPEAL FROM THE DECISION
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BRIEF FOR THE APPELLEE

JURISDICTIONAL STATEMENT

On December 6, 1999, the Commissioner mailed a notice of deficiency under § 6212 of the Internal Revenue Code of 1986 (26 U.S.C.) (IRC) 1/ to Donald G. Oren (taxpayer) and Beverly J. Oren, determining deficiencies in their federal income taxes of \$1,375,232 for 1993, \$2,138,632 for 1994 and \$1,777,271 for

1/ Unless otherwise indicated, all statutory references are to the Code.

1995. (A. 4, 6.) 2/ Under § 6213(a), taxpayer had 90 days thereafter in which to petition in the Tax Court. (*See* A. 4.) Taxpayer's petition was not filed until March 8, 2000, the 92d day after the notice was mailed. Under § 7502, however, a document received after the prescribed date is treated as timely if it bears a timely United States postmark date. Taxpayer's petition was sent by certified mail. It bore a timely private postage meter date of March 3, 2000 (Doc. 1 at 1), the same day as the United States postmark on the accompanying sender's receipt (a copy of which has been furnished to us). The postmark on the sender's receipt serves as the United States postmark date for purposes of § 7502. *See* Treas. Reg. § 301.7502-1(c)(2) (26 C.F.R.). The petition is therefore considered timely filed under § 7502. The Tax Court's jurisdiction rested upon §§ 6213(a) and 7442.

On July 24, 2002, the Tax Court (Judge Robert P. Ruwe) entered a decision sustaining the Commissioner's deficiency determinations. (A. 1.) The decision was a final, appealable order. On August 23, 2002, within 30 days after entry of decision, taxpayer filed a timely motion to vacate the decision under Tax Court Rule 162 (Doc. 15; *see* A. 2), which tolled the 90-day appeal period, and the time

2/ "App." references are to the addendum bound with appellants' brief. "A." references are to appellants' separately-bound record appendix. "Doc." references are to other documents in the original record, as numbered by the Clerk of the Tax Court.

ran anew from the denial thereof on November 5, 2002 (*see* A. 2). *See* IRC § 7483; Fed. R. App. P. 13(a)(2); Tax Ct. R. 162. Although taxpayer's notice of appeal was not filed in the Tax Court until February 7, 2003, the 94th day, it was sent by certified mail with a timely private postage meter date of January 31, 2003 (Doc. 19), the same date as the United States postmark on the accompanying sender's receipt (a copy of which has been furnished to us). The appeal is therefore timely under § 7502. *See* Fed. R. App. P. 13(b). This Court's jurisdiction rests upon § 7482(a)(1).

STATEMENT OF THE ISSUES

1. Whether the Tax Court correctly found that taxpayer's basis in two wholly-owned S corporations (and, concomitantly, his ability to deduct those corporations' losses under § 1366(d)(1)) was not increased by virtue of a series of circular loan arrangements, under which taxpayer "borrowed" funds from another controlled S corporation and then "lent" those amounts to his two loss-producing S corporations, which in turn "lent" the same amounts back to the first corporation.

The Commissioner relies primarily on the following authorities:

IRC § 1366(d)(1)

Estate of Bean v. Commissioner, 268 F.3d 553 (8th Cir. 2001)

Bergman v. United States, 174 F.3d 928 (8th Cir. 1999)

Underwood v. Commissioner, 535 F.2d 309 (5th Cir. 1976).

2. Whether the Tax Court correctly held that taxpayer's deduction of the S corporations' losses was precluded in any event, because he was not "at risk" for borrowed amounts so advanced, but was "protected against loss" under § 465(b)(4) by the offsetting obligations between himself and the corporations.

The Commissioner relies primarily on the following authorities:

IRC § 465(a), (b)(4)

American Principals Leasing Corp. v. United States, 904 F.2d 477 (9th Cir. 1990)

Moser v. Commissioner, 914 F.2d 1040 (8th Cir. 1990)

S. Rep. No. 94-938 at 49-50 (1976), *reprinted in* 1976-3 C.B. (Vol. 3) 49, 83-89.

STATEMENT OF THE CASE

Taxpayer brought this suit in the Tax Court, contesting federal income tax deficiencies for the years 1993, 1994 and 1995 that stemmed from the disallowance of net operating losses of two wholly-owned corporations that elected to be taxed under Subchapter S of the Code, IRC §§ 1361-1379. ^{3/} The Commissioner

^{3/} Subchapter S "implements a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships." *Bufferd v. Commissioner*, 506 (continued...)

determined that a series of circular loan transactions, entered into on the same day or within several days, did not give rise to shareholder basis under § 1366(d)(1), Addendum, *infra*, which limits a shareholder's ability to deduct corporate losses to his basis in his stock and the corporation's indebtedness to him. In any event, the Commissioner further determined, taxpayer was not "at risk" under § 465, Addendum, *infra*, with respect to borrowed amounts so advanced because the offsetting nature of the obligations amounted to a "stop-loss" arrangement under § 465(b)(4) that protected him from loss. Following a short trial (A. 56-138), the Tax Court issued a memorandum opinion (App. 1a-37a), unofficially reported at 84 T.C.M. (CCH) 50 (2002), sustaining the deficiencies. Taxpayer now appeals.

STATEMENT OF FACTS

A. *The Dart Companies*

Taxpayer and, in some cases, his wife, children and trusts for the children's benefit owned stock in several S corporations (the Dart Companies): Dart Transit Company (Dart), Highway Leasing (HL), Highway Sales (HS), all electing to be taxed as S corporations, and Fleetline, Inc. (Fleetline). ^{4/} (App. 4a-5a.) Those

^{3/}(...continued)

U.S. 523, 525 (1993).

^{4/} Dart had accumulated earnings and profits attributable to its former status as
(continued...)

corporations performed various functions for taxpayer's trucking business. (App. 2a; A. 33.) The various Dart Companies were maintained as separate entities in part to limit their exposure to tort liability by keeping assets out of the primary truckload carriers, Dart and Fleetline, to enhance operational flexibility and to simplify rate-making. (A. 89-91, 290-292; *see* App. 6a-7a.) The Dart Companies were insured under a general liability policy with a \$1 million retention, increased to \$2 million in 1994, with coverage of \$34 million per claim. (A. 48, 179, 194.)

1. *Dart Transit Company*

Taxpayer was the president, treasurer and controlling shareholder of Dart Transit Company (Dart), the nation's 59th largest motor carrier. (App. 3a; A. 7, 26, 285.) He and Mrs. Oren, who served as Dart's vice president and secretary, were its only directors. (App. 3a; A. 26.)

Dart provides "truckload" carrier service for retailers and manufacturers throughout the 48 contiguous states and in some provinces of Canada. (App. 2a; A. 33-34, 36.) Truckload shippers pay for the use of an entire trailer, load it at their own plant site and consign the load to a single customer, moving loads directly from origin to destination. (A. 33.)

4/(...continued)
a C corporation. (App. 4a & n.2; A. 22, 123.)

Dart does not own tractors or employ drivers, but relies exclusively upon independent contractors, who own or lease the tractors they operate. (A. 35, 36.) Dart's contractors increased in number from 1,150 in 1993 to 1,341 in 1994 and 1,416 in 1995. (A. 36.) The number of trailers owned by Dart also increased from 1,669 in 1993 and 1994 to 2,066 in 1995. (A. 38.) Dart had revenues from truckload carrier services of \$130,034,000 in 1993, \$149,039,000 in 1994 and \$168,172,000 in 1995. (App. 3a; A. 37.)

Dart's common stock consisted of 33,000 Class A voting shares owned entirely by taxpayer and 3,267,000 Class B non-voting shares divided among Mrs. Oren, the Orens' four children and irrevocable trusts for the children's benefit. (App. 4a; A. 5-6.) In 1993, taking both classes together, taxpayer owned 74.94 percent of Dart's stock, Mrs. Oren owned 6.33 percent, each of the four children owned 0.26 percent and each child's trust owned 4.43 percent. ^{5/} (App. 6-7.) In 1994, while Mrs. Oren's and each child's trust's ownership percentage remained the same, taxpayer's ownership percentage decreased to 54.95 percent overall and

^{5/} Taxpayer's adult sons, David, Daniel and Bradley, were employed by Advantage Management Corp., which provided various services to the Dart Companies and was partly owned by taxpayer, to whom Daniel and David reported. (A. 48, 86, 152, 269-272.) The fourth child, Angela, was a minor. (A. 24.)

each child's ownership increased to 5.25 percent. (App. 4a; A. 7.) The holdings of the children and the trusts resulted from a program of regular annual giving of Dart shares undertaken by taxpayer and his wife for estate planning purposes. (App. 4a-5a; A. 23, 25, 86-88.)

2. *Highway Leasing*

Highway Leasing (HL) was incorporated in Minnesota in 1987 with a single class of stock owned entirely by taxpayer, who was also its only director. (App. 5a; A. 28-29.) Taxpayer served as president/treasurer, while Mrs. Oren was vice president/secretary. (App. 5a; A. 29.) HL was in the business of acquiring trailers and leasing them to Dart and outside parties. (App. 5a; A. 41, 42.) The number of trailers owned by HL rose by 86 percent from 1993 through 1995, or from 2,068 in 1993 to 2,550 in 1994 and 3,847 in 1995. (App. 41.)

HL's reported revenues/gross receipts grew from \$6,295,000 in 1993 to \$8,587,000 in 1994 and \$10,919,000 in 1995, an increase of about 73 percent. (App. 5a; A. 41.) Its reported net income per books climbed from \$965,237 in 1993 to \$2,447,233 in 1995 after falling to \$635,746 in 1994. (App. 5a; A. 42.) Due to the accelerated depreciation deductions associated with its trailer acquisitions, HL showed ordinary losses of \$2,845,625 for 1993, \$4,459,488 for 1994 and \$6,825,523 for 1995. (*Id.*)

3. *Highway Sales*

Highway Sales (HS), incorporated in 1971 in Minnesota, also had one class of stock owned entirely by taxpayer. (App. 5a; A. 27.) Its only directors were taxpayer, who served as treasurer, and Mrs. Oren, who served as vice president/secretary. (App. 6a; A. 27.)

HS purchased and leased tractors in a “lease-to-purchase” program for contractors. (App. 6a; A. 39, 288-289.) HS had 852 tractors on lease in 1993, 1,231 in 1994 and 1,184 in 1995. (App. 6a; A. 39.) The number of Dart and Fleetline contractors leasing trailers from HS rose from 739 in 1993, representing 41 percent of Dart and Fleetline’s total contractors, to 1,059, or 48 percent of the total, in 1994, before decreasing to 929, or 40 percent of the total, in 1995. (A. 40.)

HS reported revenue/gross receipts from its tractor leases of \$8,361,000 in 1993, \$11,202,000 in 1994 and \$13,798,000 in 1995, yielding net income for book purposes of \$1,634,071 in 1993, \$322,689 in 1994 and \$1,451,609 in 1995. (App. 6a; A. 40, 41.) As with HL, the accelerated depreciation deductions arising from tractor purchases by HS produced ordinary losses of \$1,511,830 in 1993 and \$1,773,473 in 1994, although HS showed an operating profit of \$482,405 in 1995. (App. 6a; A. 41.)

B. *The disputed loan arrangements* 6/

1. *Background*

Taxpayer and his wife retained Deloitte & Touche to advise them in personal financial matters, including the preparation of their joint federal income tax returns, as well as to provide tax and financial accounting services to the Dart Companies.

(A. 91, 125; *see* Jt. Exs. 1-3, 5-10, 12-14, 27-29, 34-36.) In preparing the 1992 federal income tax return (Form 1120-S) for HL, Deloitte & Touche recognized that the operating loss associated with HL's depreciation deductions exceeded Mr. Oren's investment in HL and, to that extent, was subject to deferral under § 1366(d)(2). (A. 47, 91-92; *see* App. 7a.) Deloitte & Touche projected that losses in excess of taxpayer's basis in HL would continue for a number of years.

(A. 47.)

Deloitte & Touche accordingly recommended that taxpayer "restructure" his investments in the Dart Companies, which were concentrated in Dart itself, in order to receive a current tax benefit from HL's net operating losses. (A. 47, 92.) Dart, taxpayer, HL and HS therefore undertook a program of loans that were intended to

6/ In their stipulation of facts, the parties noted that "The use of the terms 'loan', 'debt', 'borrowing', or derivations thereof is for the convenience of the parties and does not represent a concession by [the Commissioner]." (A. 18.) Here, too, we use the terms for convenience only.

increase taxpayer's basis in HL, as well as his basis in HS in 1995. (*See* A. 30-33, 47-48, 91-93, 117; App. 8a.) Taxpayer financed his own participation with \$200,000 of personal funds and \$15,355,750 borrowed from Dart. (*See* A. 30-33, 45, 257.)

Under a 1991 credit agreement with First Bank National Association (First Bank) (the First Bank agreement), distributions by the Dart Companies had been limited to the Orens' expected tax liability, plus 10 percent of net income. (App. 7a; A. 119.) In August, 1993, the credit agreement was amended to allow distributions to the Orens to the extent that they made equivalent cash contributions to one of the other Dart Companies. (App. 7a; *see* A. 30, 119, 124.) The amended agreement specifically permitted loans by Dart to taxpayer, "but only as long as contemporaneous loans of equal amount from Donald G. Oren to another [of the Dart Companies] remain outstanding." (App. 7a.) All of the loans were made with the First Bank's knowledge and without violating the lending agreement. (A. 45.)

Taxpayer and his wife deducted the following losses from HL and HS on their joint federal income tax returns:

	<i>1993</i>	<i>1994</i>	<i>1995</i>
HL	(\$4,000,000)	(\$4,614,944)	(\$5,605,248)
HS	(146,384)	(66,363)	(2,046,251)

(A. 16a.)

2. *The 1993 loans*

On December 22, 1993, Dart lent taxpayer \$4,000,000 and received a note from him for \$4,000,000 (the “1993 Oren Note”). (App. 8a; A. 30, 212.) The 1993 Oren Note provided that the loan was due 375 days following demand and that interest would accrue at the rate of 7 percent annually. (*Id.*) Interest was due on the first anniversary of the note’s execution and on the same day of each year thereafter. (*Id.*) The loan proceeds were provided to taxpayer by a check drawn on First Bank Havre (FBH). (App. 8a; A. 224.) Dart maintained a zero balance account with that bank, meaning that it would be drawing on its line of credit each time it wrote a check. (App. 8a n.4; A. 118.)

Also on December 22, 1993, taxpayer lent \$4,000,000 to HL by check and received a note from HL for \$4,000,000 on terms identical to those of the 1993 Oren Note. (App. 8a; A. 30, 213, 224.) In addition, HL lent \$4,000,000 back to

Dart on December 22, 1993 and received a note from Dart for \$4,000,000. ^{7/} (App. 9a; A. 30, 214.) Again, the terms of the note were identical to those of the 1993 Oren Note, and the loan proceeds were provided to Dart by a check drawn on First Bank Minneapolis (FBM). (App. 9a; A. 30, 224.) Taxpayer signed all three notes either in his individual capacity or as president of Dart or HL. (A. 212-214.)

3. *The 1994 loans*

On September 22, 1994, Dart, taxpayer and HL executed a series of loans following the same pattern. (App. 9a-10a; A. 30-31.) Dart lent \$5 million to taxpayer in return for a note with terms identical to those of the 1993 Oren Note, and it distributed the proceeds by a wire transfer from First Bank to his account with Fidelity Investments (Fidelity). (App. 9a; A. 30-31, 215, 224.) Taxpayer lent \$5,000,000 to HL by a check drawn on the Fidelity account, in return for a note with identical terms. (App. 9a; A. 31, 216, 224.) HL lent \$5,000,000 back to Dart by a check drawn on FBH, and it received a note from Dart with identical terms. (App. 9a-10a; A. 31, 217, 224.) Taxpayer signed all three notes. (A. 215-217.)

^{7/} Taxpayer testified that the funds he lent to HL and HS were “reloaned back to Dart” because “it became evident that Dart needed the money.” (A. 92.) He explained that “Dart always has debt and cash flow problems and so Dart borrowed the money back” (A. 92-93.)

4. *The 1995 loans*

In 1995, taxpayer lent HL \$100,000 more than he borrowed from Dart. First, on September 15, 1995, Dart lent \$4,400,000 to taxpayer in return for a note with identical terms to those used in the two previous years, and it provided the proceeds to him by a check drawn on FBH. (App. 10a; A. 31, 218, 224.) Next, on September 27, 1995, taxpayer lent \$4,500,000 to HL in return for a note in that amount with identical terms, and he provided the proceeds to HL by check. (App. 10a; A. 32, 219, 225.) Also on September 27, 1995, HL lent \$4,500,000 back to Dart by a check drawn on FBH in return for a note with identical terms. (App. 10a-11a; A. 32, 220, 225.)

Dart and taxpayer entered into a parallel arrangement with HS in 1995, after Deloitte & Touche made the same recommendation for a “restructuring” of taxpayer’s investments, this time to take advantage of losses arising from accelerated depreciation deductions for tractors owned by HS. (A. 47-48; *see* App. 11a.) On December 8, 1995, Dart lent \$1,900,000 to taxpayer in return for a note with terms identical to all the others, and it provided the proceeds to him by a check drawn on FBH. (App. 11a; A. 32, 221, 225.) On December 21, 1995, taxpayer lent \$2,000,000 to HS by check. (App. 22a; A. 33, 222, 225.) That same day, HS lent that same amount back to Dart by a check drawn on FBM. (App.

22a; A. 33, 223, 225.) Again, the terms of the notes from taxpayer to HS and HS back to Dart were identical to all the others. (App. 11a-12a; A. 32-33.) Taxpayer signed his note to Dart individually and the note from Dart to HS as Dart's president. (A. 221, 223; *see* App. 12a.) The note to taxpayer was signed by John Siebel, the president of HS. (App. 12a; A. 222.)

5. *Accounting treatment of the loans*

Taxpayer's personal financial statements for 1993 and 1995 do not reflect his loans to Dart or the loans from HL and HS to him. (App. 12a; *see* A. 139-165.) The 1993 and 1994 combined balance sheets for the Dart Companies also do not reflect the loans among Dart, taxpayer and HL. (App. 12a; *see* A. 166-211.) The 1995 combined balance sheet for the Dart Companies reflects the \$200,000 that taxpayer lent to HL and HS from his own funds as notes payable to a stockholder. (App. 12a-13a; *see* A. 210.)

6. *Payments with respect to the loans*

The record does not reflect that any of the parties made a demand for payment from 1993 through 1995, nor was any principal in fact repaid. (A. 45, 116.) From 1994 through 1996, each of the parties paid interest on the loans. (A. 44.)

On December 21, 1994, HL paid interest of \$280,000 to taxpayer, who on December 22, 1994, paid the same amount to Dart, which made an identical payment to HL on December 23, 1994. (App. 14a; A. 224.) On September 27, 1995, by means of checks drawn on FBH, Dart paid HL, and HL paid taxpayer, interest of \$553,288. (App. 14a; A. 224-225.) Taxpayer in turn paid the same amount to Dart on October 11, 1995. (App. 14a; A. 225.) On December 3, 1996, HL paid interest of \$1,121,917.81 to taxpayer by a check drawn on FBH; Dart paid the same amount to HL on December 4, 1996, by a check drawn on FBH; and taxpayer paid interest of \$1,254,246.58 to Dart on December 12, 1996. (App. 14a-15a; A. 225) Also on December 4, 1996, Dart paid interest of \$132,712.33 to HS, which paid the same amount to taxpayer. (*Id.*)

All of the notes were satisfied in 1996 after the Commissioner challenged taxpayer's loss deductions upon audit of his returns for 1993, 1994 and 1995. (A. 28, 93-94.) On December 19, 1996, Dart paid \$13,549,191.78 to HL by a check drawn on FBH, and HL paid the same total amount to taxpayer by two checks drawn on FBH. (App. 15a; A. 226.) Also on December 19, 1996, Dart paid \$2,007,287.67 to HS by a check drawn on FBH, and HS paid the same total amount to taxpayer by two checks drawn on FBM. (App. 15a; A. 225.) The notes from Dart to HL and HS were marked "Paid 12/19/96 check," referring to check

numbers 187346 and 187347, respectively, and those from HL and HS to taxpayer were marked “Contribute to Capital * * * 12/18/96.” (App. 15a; A. 212-223.)

On December 23, 1996, taxpayer satisfied his notes to Dart by endorsing the checks he had received from HL and HS, depositing them in Dart’s account with First Bank St. Paul and indicating that method of payment on the notes themselves. (App. 16a; A. 45, 226, 257.) Taxpayer made capital contributions of \$1,301,264.64 and \$1,198,735.36 to HS on the same date, followed by a capital contribution of \$16.5 million to HL on December 27, 1996. (App. 16a; A. 121, 273.) The latter two amounts were paid by checks drawn on First Bank St. Paul. (App. 94-95, 273.) On the recommendation of Deloitte & Touche, taxpayer funded all three capital contributions with dividend distributions made by Dart. (A. 94, 96; *see* App. 16a.)

C. *The Tax Court proceeding*

Upon audit, the Commissioner determined that the above loan arrangements “do not create indebtedness and at-risk basis.” (App. 17a.) He therefore disallowed the deductions for the 1993 and 1994 losses of HL and reduced the 1995 deductions for the losses of both HL and HS by the amount of the loans. (*Id.*) To the extent that taxpayer lent \$100,000 each to HL and to HS in 1995 using his own funds, however, the Commissioner allowed him basis. (*See id.*)

Taxpayer contested the resulting deficiencies in the Tax Court. 8/ (Doc. 1.) After a trial, the Tax Court sustained the deficiencies. (App. 1a-37a.) First, the court concluded that taxpayer's loans to HL and HS did not result in any indebtedness of those corporations to him under § 1366(d) because they did not entail an "actual economic outlay." (App. 17a-29a.) In rejecting taxpayer's argument that "the 'form' of a direct loan from a shareholder to an S corporation is sufficient to increase basis," the Tax Court relied upon *Bergman v. United States*, 174 F.3d 928, 932 (8th Cir. 1999), where this Court stated that "[t]he principle underlying the [economic outlay] doctrine extends beyond [loan guarantees] to transactions which purport to be direct loans." (App. 20a-21a.)

The Tax Court explained that the loan transactions among the Dart Companies and taxpayer "were the equivalent of offsetting bookkeeping entries" that "did not have a net economic effect." (App. 21a.) "None of the \$4 million that Dart lent to Mr. Oren [in 1993] was retained by a party other than Dart," the court said. (*Id.*) "[T]he loans to HL and HS simply entered the 'front door,' immediately exited through the 'back door,' and were returned to Dart." (*Id.*,

8/ Taxpayer also filed a protective refund claim for 1996, asserting that his capital contributions to HL and HS created sufficient basis to allow deduction of the losses in that year, if he should not prevail in this case. (A. 274-276.)

n.12.) The court further observed that the notes did not carry “terms which might appear in notes executed for the benefit of unrelated third parties, especially in light of the size of the loans,” that taxpayer and his wife “controlled when and whether a demand for repayment would be made” and that the “interest payments, like the disbursements and repayments, were wholly circular.” (App. 22a-23a.) The court also concluded that “a default on the notes by any of the Dart companies was highly unlikely” and that it was “highly improbable” that Dart would have called its loan to taxpayer. (App. 25a; *see* App. 26a-29a.)

The Tax Court went on to conclude that, in any event, taxpayer was not “at risk” under § 465 for borrowed amounts advanced to HL and HS. (App. 37a; *see generally* App. 29a-37a.) Citing *Moser v. Commissioner*, 914 F.2d 1040 (8th Cir. 1990), the Tax Court noted that a taxpayer is not at risk with respect to borrowed amounts unless there is a “realistic possibility of loss.” (App. 31a.) The court rejected taxpayer’s contention that *Moser* applied only to sale-leaseback transactions, reasoning that “the facts in this case are decidedly similar to those involved in the typical sale-leaseback scenario.” (App. 31a-32a.)

The court rejected taxpayer’s argument that “there was a realistic possibility that the circular chain of loan and interest payments would be broken.” (App. 32a.) The court observed that taxpayer was “insulated from actually repaying the Dart

loans from his own personal resources,” unless he chose to do so or one of the Dart Companies became insolvent or bankrupt. (App. 33a.) Although taxpayer emphasized the truckload carriers’ exposure to tort liability, the court pointed out that the Dart Companies had “significant cashflow and assets” from which to satisfy potential claims of up to \$2 million and insurance coverage in excess of that amount of up to \$34 million. (App. 33a-34a.) The court noted that there was no proof other than taxpayer’s self-serving and speculative testimony concerning the likelihood that claims in excess of \$34 million might be made. (App. 34a.)

The court also disagreed with taxpayer’s suggestion that the elimination of shareholder equity due to a decline in equipment values or an economic slowdown might prevent HL and HS from repaying him, because those companies “could have simply passed on the Dart notes to Mr. Oren,” who “could then offset his own obligations to Dart by canceling the Dart notes.” (App. 35a.) In any event, the court observed, “the legislative history of section 465(b)(4) indicates that Congress intended to exclude financial difficulties from the at-risk determination.” (App. 36a.) Finally, the court stated that “examination of ‘the worst-case scenario’ is generally inappropriate” under *Moser*, and it declined to “utilize such a ‘doomsday’ approach.” (App. 36a-37a.)

SUMMARY OF ARGUMENT

1. Section 1366(a) permits each shareholder of an S corporation to deduct his proportionate share of any net operating loss sustained by the corporation. Section 1366(d)(1), however, limits amount of the shareholder's net operating loss passthrough deduction to the sum of the shareholder's basis in his stock and the basis of any indebtedness of the corporation to the shareholder. The legislative history of this provision shows that it was intended to limit the shareholder's deduction to the amount of his economic investment in the corporation, thereby precluding loss deductions in excess of the shareholder's actual economic loss.

In this case, taxpayer owned two S corporations, HL and HS, that incurred substantial net operating losses and owner of all of the voting stock. He also controlled a third, a profitable S corporation, Dart. Taxpayer was informed by his accountants that his basis in HL and HS would soon be exhausted (and with it, his ability to deduct currently their net operating losses on his individual tax returns under § 1366). In an effort to generate basis in the corporations, taxpayer and the corporations entered into a series of circular loan arrangements under which Dart lent funds that it had obtained under a bank line of credit to taxpayer, who made loans in like amounts to HL or HS, which then lent the same amounts back to Dart,

all on the same day or within a matter of days. Taxpayer executed the notes for all the loans, save one. The unsecured notes, moreover, carried identical terms, including repayment upon demand plus 375 days, and the loan proceeds and subsequent interest payments were transferred simultaneously or nearly so.

In line with this Court's opinion in *Bergman v. United States*, 174 F.2d 928 (8th Cir. 1999), the Tax Court correctly found that the circular loan arrangements did not increase taxpayer's basis in HL and HS because they resulted in no actual economic outlay that left him poorer in a material sense. Taxpayer essentially served as a conduit for funds that originated with Dart and returned to Dart the same day or within a matter of days. Taxpayer's "loans" to HL and HS, like the surrounding transactions, were tantamount to offsetting bookkeeping entries that left the parties' economic positions unchanged. Since taxpayer controlled all parties to the arrangement, the possibility was remote that the circular flow of funds could be interrupted by a default on the part of HL or HS, leaving taxpayer with an outright obligation to repay Dart, and taxpayer conceded that such a default was unlikely in any event.

2. Even if the transactions in question gave rise to indebtedness of HL and HS to taxpayer, taxpayer still is not entitled to a deduction for funds borrowed from Dart and so advanced. Section 465(a) limits losses from certain activities,

including equipment leasing, in which HL and HS were engaged, to the amount for which a shareholder is “at risk.” Although § 465(b) generally provides that a shareholder is at risk for amounts borrowed with respect to an activity, § 465(b)(4) specifically excludes borrowed amounts that are “protected against loss through non-recourse financing, guarantees, stop loss agreements, or other similar arrangements.” In *Moser v. Commissioner*, 914 F.2d 1040 (8th Cir. 1990), this court held that the test for determining whether a taxpayer is at risk within the meaning of § 465(b)(4) is whether the transaction is structured, by whatever method, to remove any realistic possibility of economic loss.

Here, the Tax Court correctly held that taxpayer was not at risk for his loans to HL and HS. By giving each party an offsetting claim against the others, the circular arrangements effectively removed any realistic possibility that taxpayer, who controlled all the parties, would face a demand for repayment from Dart, yet be unable to seek repayment from HL and HS. Although taxpayer argued that a default by HL or HS could interrupt the chain of payments, the court correctly found that that scenario was highly unlikely, and it properly declined to utilize such a “worst-case” approach.

The decision of the Tax Court should be affirmed.

ARGUMENT

I

THE TAX COURT CORRECTLY FOUND THAT A CIRCULAR SERIES OF TRANSACTIONS BY WHICH TAXPAYER “BORROWED” FUNDS FROM DART AND “LENT” THEM TO HL AND HS, WHICH THEN “LENT” THE BORROWED FUNDS BACK TO DART, DID NOT RESULT IN AN ACTUAL ECONOMIC OUTLAY BY TAXPAYER THAT COULD INCREASE SHAREHOLDER BASIS

Standard of Review

Contrary to taxpayer’s blanket assertion (Br. 19), the Tax Court’s finding, after trial, that taxpayer did not make an economic outlay giving rise to shareholder basis in HL and HS for purposes of the limitation on loss passthrough under § 1366(d)(1) is one of fact reviewed for clear error. *See Estate of Bean*, 268 F.3d 553, 556, 557 (8th Cir. 2001).

A. *Introduction*

1. The income of an S corporation is not subject to the corporate income tax, but is taxed *pro rata* to the shareholders. IRC §§ 1363, 1366. Any net operating loss incurred by an S corporation is passed through to the shareholders, each of whom is entitled to deduct on his individual return his proportionate share of the loss. IRC § 1366(a)(1), (c); *see Parrish v. Commissioner*, 168 F.2d 1098,

1101 (8th Cir. 1999). Under § 1366(d)(1), however, the amount of a corporation's net operating loss that is deductible by a shareholder is limited to the sum of (1) the shareholder's adjusted basis in the corporation's stock and (2) the adjusted basis of any indebtedness of the corporation to the shareholder. *See Estate of Bean*, 268 F.3d at 556; *Bergman v. United States*, 174 F.3d 928, 931-32 (8th Cir. 1999). The taxpayer bears the burden of proving that he has sufficient basis in the corporation to deduct its loss. *Estate of Bean*, 268 F.3d at 556. Any loss or deduction disallowed by reason of the fact that the shareholder lacks sufficient basis to absorb the loss is treated "as incurred by the corporation in the succeeding taxable year with respect to that shareholder." IRC § 1366(d)(2); *Estate of Bean*, 268 F.3d at 556.

The legislative history of this provision indicates that Congress intended to limit the amount of a shareholder's deductible loss from an S corporation to his "investment" in the corporation, *i.e.*, the combined amount of his adjusted basis in his stock and the corporation's indebtedness to him. S. Rep. No. 1983, 85th Cong., 2d Sess. 220 (1958) (1958-3 C.B. 922, 1141) (emphasis added). That report further states that "The losses that he may take, however, are limited to the basis he has for the stock. Thus, his basis for the stock cannot be reduced below zero." *Id.* at 88 (1958-3 C.B. at 1009). As this Court noted in *Bergman*, 174

F.3d at 391, “This limitation prevents a shareholder from deducting more than he has invested in the corporation.”

In light of this clear Congressional directive, the courts, almost without exception, have interpreted the limitation of S corporation deductions to a shareholder’s “investment” to require that some “actual economic outlay” be made by the shareholder claiming the deduction, thereby precluding deductions that exceed the shareholder’s out-of-pocket expenditures. The seminal formulation of the “actual economic outlay” approach is found in *Perry v. Commissioner*, 54 T.C. 1293, 1295-96 (1970), *aff’d on the basis of the Tax Court opinion*, 71-2 U.S. Tax Cas. (CCH) ¶ 9502 (8th Cir. 1971), where the court held that the shareholder’s issuance of a demand note to his S corporation in return for the corporation’s long-term note to him in like amount gave rise to no basis in the corporation. The Tax Court characterized the “posting of offsetting book entries” as “illusory,” noting that “in pure, pragmatic terms the exchanges of notes which generated [the S corporation’s] long-term “indebtedness” left [the taxpayer-shareholder] economically unimpaired, both actually and constructively.” 54 T.C. at 1296. The court quoted the language of the 1958 Senate report (S. Rep. No. 1983, *supra*, 1958-3 C.B. 1141), and stated: “The use of the word ‘investment’ reveals an intent, on the part of the committee, to limit the applicability of section 1374(c)(2)(B) to

the actual economic outlay of the shareholder in question.” 54 T.C. at 1296 (footnote omitted). It then held that a taxpayer claiming a deduction must show that it was based on “ . . . some transaction which when fully consummated left the taxpayer poorer in a material sense.” *Id.* (quoting *Horne v. Commissioner*, 5 T.C. 250 (1945), and it then quoted, 54 T.C. at 1297, from this Court’s decision in *Shoenberg v. Commissioner*, 77 F.2d 446, 449 (8th Cir.), *cert. denied*, 296 U.S. 586 (1935)):

To secure a deduction, the statute requires that an actual loss be sustained. An actual loss is not sustained unless when the entire transaction is concluded the taxpayer is poorer to the extent of the loss claimed; in other words, he has that much less than before.

. . . . Taxation is concerned with realities, and no loss is deductible which is not real.

Perry, 54 T.C. at 1297 (quoting *Shoenberg*, 77 F.2d at 449).

The “actual economic outlay” requirement has frequently been applied in cases involving shareholder guarantees of bank loans to the corporation, and the courts generally have held that to give rise to basis, the indebtedness of the S corporation must run directly to the shareholders. Because a guarantor is only secondarily and conditionally liable, and does not become subrogated until he makes good on the principal’s default, *see Putnam v. Commissioner*, 352 U.S. 82, 85 (1956), a guarantor-shareholder makes no economic outlay, and no real

investment, until he actually makes a payment on the guaranty. As a result, the courts generally have refused to recast such corporate loans as having been made to the shareholders, followed by their contribution of the loan proceeds to the capital of the corporation, because the transaction comported with its form, because there was no actual economic outlay on the shareholder's part, or both.

E.g., Sleiman v. Commissioner, 187 F.2d 1352, 1357-59 (11th Cir. 1999); *Reser v. Commissioner*, 112 F.3d 1258, 1264-65 (5th Cir. 1997); *Uri v. Commissioner*, 949 F.2d 371, 373-374 (10th Cir. 1991); *Goatcher v. United States*, 944 F.2d 747, 752 (10th Cir. 1991); *Harris v. United States*, 902 F.2d 439 (5th Cir. 1990); *Estate of Leavitt v. Commissioner*, 875 F.2d 420, 422 (4th Cir. 1989); *Brown v. Commissioner*, 706 F.2d 755, 757 (6th Cir. 1983); *Wheat v. United States*, 353 F. Supp. 720, 722-723 (S.D. Tex. 1973); *Neal v. United States*, 313 F. Supp. 393, 398 (C.D. Cal. 1970); *Calcutt v. Commissioner*, 91 T.C. 14, 24 (1988); *Raynor v. Commissioner*, 50 T.C. 762, 770 (1968); *but see Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985) (concluding that triable issue of fact existed whether requisite outlay arose upon shareholder guarantee, coupled with pledge of noncorporate assets, upon bank-requested conversion of shareholder bank loan to corporate bank loan).

As was recognized both by this Court in *Bergman*, 174 F.3d at 933, and by the Tax Court in this case (App. 20a-21a; quoting *Bergman*), “[t]he economic outlay doctrine does not apply only to loan guarantees.” For example, in *Estate of Bean*, in concluding that a shareholder guarantee and pledge of security for a bank loan to an S corporation did not give rise to shareholder basis, this Court observed that “a mortgage or pledge of other property is similar to a guaranty.” 268 F.3d at 558. Extrapolating from the rule that “a mere guaranty of a corporate loan is insufficient to give . . . basis for the amount of the loan,” this Court held that “[u]ntil the mortgage is called to satisfy the corporation’s debt, . . . the shareholder has not suffered an economic outlay and is not entitled to an increase in basis.” *Id.* at 559. Similarly, in *Grojean v. Commissioner*, 248 F.3d 572, 576 (7th Cir. 2001), the court held that a shareholder’s acquisition of a “participation” in a bank loan to his S corporation was in substance a guarantee, and it refused to allow him to recast the transaction as a bank loan to him, followed by his advancement of the loan proceeds to the S corporation. As the court explained in *Raynor*, 50 T.C. at 770-71:

No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation. Prior to that crucial act, ‘liability’ may exist, but not debt to shareholders.

In keeping with the statutory imperative, endorsed in *Perry, Estate of Bean* and the loan guaranty cases, that indebtedness must run directly from the corporation to shareholder to give rise to basis, it is also well settled that no basis to the shareholder arises when funds are advanced to an S corporation by another entity closely related to the shareholder. *Bergman*, 174 F.3d at 932 (related corporation); *Frankel v. Commissioner*, 61 T.C. 343 (1973), *aff'd without published opinion*, 506 F.2d 1051 (3d Cir. 1974) (partnership); *Prashker v. Commissioner*, 59 T.C. 172 (1972) (estate); *Robertson v. United States*, 73-2 U.S. Tax Cas. (CCH) ¶ 9,645 (D. Nev. 1973) (trust).

In a similar vein, there have been several cases, closely scrutinized by the courts where they involve only related parties, where an unprofitable S corporation first borrows from a profitable corporation owned by the same shareholders, and some attempt at restructuring the loan transaction is then made to give the shareholders basis. Such an attempt foundered in *Underwood v. Commissioner*, 535 F.2d 309, 312 (5th Cir. 1976). There, the taxpayers owned two corporations, Albuquerque, an S corporation, and Lubbock. Lubbock was profitable, but Albuquerque was not. Lubbock had made a series of loans to Albuquerque in return for demand notes. Prompted by their accountant's advice that

Albuquerque's losses would soon exhaust their basis (and with it, their ability to deduct those losses), the taxpayers substituted their personal demand notes in the amount of Albuquerque's outstanding debt to Lubbock for those of Albuquerque and caused Lubbock to cancel Albuquerque's indebtedness. Albuquerque simultaneously issued the taxpayers a demand note in the identical amount at the same interest rate. Lubbock accrued and reported interest due on Albuquerque's note, and the taxpayers and Albuquerque made some interest payments. *Id.* at 311.

Despite the care taken with the formalities of this series of transactions, the Fifth Circuit held in *Underwood* that the taxpayers' basis in Albuquerque was not increased. The court noted that there is no increase in basis unless there is an "actual economic outlay" that leaves the taxpayer "poorer in a material sense." 535 F.2d at 311, *quoting Perry*, 54 T.C. at 1296. The court concluded that no increase in basis resulted from the restructuring of debt. It noted that the taxpayers had "advanced no funds" to Lubbock or Albuquerque, but had "merely exchanged demand notes between themselves and their wholly owned corporations." *Id.* at 311.

A similar attempt to restructure a debt from the taxpayer's profitable S corporation to his loss S corporation as one directly from the taxpayer to the loss corporation was rejected by this Court in *Bergman, supra*. There, this Court

extended the principle underlying the economic outlay doctrine “to transactions which purport to be *direct* loans.” 174 F.3d at 933 (emphasis added). The court reiterated that “[t]ransactions which are purported to create loans from shareholders to S corporations to not create basis if there has been no actual outlay of the *shareholder’s* funds.” *Id.* (emphasis added).

In *Bergman*, in a series of circular transactions at the same bank on the same day, the loss corporation had purported to repay the debt to the profitable corporation, which then lent the same amount to the taxpayer-shareholder, who then lent the funds to the loss corporation. The District Court granted the taxpayer summary judgment over the Government’s objection that there should be a trial on the genuineness of the supposed flow of funds, given that the loss corporation lacked the apparent wherewithal to make the first step of repaying the loan from its sister corporation. This Court reversed and remanded for trial, considering *Underwood* to be directly in point. 174 F.3d at 933-34. It also observed that the restructuring transactions “could be viewed as merely a series of offsetting entries among bank accounts held in the same bank by entities controlled by Bergman.” *Id.* at 934.

To the same effect as *Underwood* and *Bergman* is the decision in *Hitchins v. Commissioner*, 103 T.C. 711, 717 (1994). In that case, the Tax Court held that

an S corporation's assumption of a debt owed its shareholder by a related C corporation, in satisfaction of a liability owed by the S corporation to the C corporation, gave rise to no shareholder basis, because the C corporation remained liable on its debt as a surety, and its obligation was not completely extinguished. ^{9/}

On the other hand, if the shareholder gives his note to a bank (as opposed to a related entity) in return for funds that he then contributes to the corporation, *see Bolding v. Commissioner*, 117 F.3d 270, 272 (5th Cir. 1999), or gives such a note in satisfaction of a guarantee of a loan to a defaulting S corporation, *see* Rev. Rul.

^{9/} It is also clear that the mere making of book entries converting intercorporate loan accounts into loans due the shareholder does not give rise to basis. *Griffith v. Commissioner*, 56 T.C.M. (CCH) 220 (1988) (no basis resulted where the taxpayer "interjected himself individually into the middle of the transactions" by netting his individual loans payable accounts to several corporations against such corporations' outstanding loan balances to other related corporations), *reconsideration granted in part on other issues*, 56 T.C.M. (CCH) 1263 (1989); *Burnstein v. Commissioner*, 47 T.C.M. (CCH) 1100 (1984) (no basis resulted from year-end amendment of book entries purporting to convert open account between corporations as advances from shareholders to debtor corporation). Nor has the distribution of the loss corporation's note from the profitable corporation to the shareholders resulted in basis, despite the fact that the shareholders reported income from the receipt of the note. *Wilson v. Commissioner*, 62 T.C.M. (CCH) 1122 (1991). And in *Shebester v. Commissioner*, 53 T.C.M. (CCH) 824 (1987), no basis increase resulted from a shareholder's assumption of the debtor corporation's debt to the creditor corporation, shown on the creditor's books as a credit to debtor's loan account and a contemporaneous draw to shareholder, even though the draw was charged against the shareholder's share of the creditor corporation's undistributed taxable income at year's end.

75-144, 1975-1 C.B. 277; *see also* *Gilday v. Commissioner*, 42 T.C.M. (CCH) 1295 (1982), then basis is immediately achieved, even though the shareholder is not yet out of pocket on his note. The transaction with the bank being at arm's length, he ultimately will have to pay.

A successful loan restructuring that gave rise to basis occurred in *Gilday*, where the facts fell neatly within the scope of Revenue Ruling 75-144, 1975-1 C.B. 277. There, an S corporation first borrowed funds from a bank, and its shareholders guaranteed the loan. Later that same year, the shareholders gave the bank their own note for these prior advances to the corporation, and the bank canceled the corporation's note. It followed from Revenue Ruling 75-144, the Tax Court held, that this transaction gave rise to basis in the corporation, because the shareholders were the primary obligors on the bank loan, rather than mere guarantors of the corporation's liability.

Significantly, the Fifth Circuit in *Underwood* rejected the reliance of the taxpayers there upon Revenue Ruling 75-144. The court commented that "the factual situation in the ruling is significantly different and warrants disparate treatment" because the obligee on the shareholders' note was "an outsider, a bank, which stood ready to enforce the obligation," whereas "[h]ere, by contrast, the obligee on the taxpayers' demand note was their own wholly-owned corporation,"

and “[i]t was not clear from the outset that the taxpayers would ever make a demand upon themselves (through Lubbock) for payment of the note.” 535 F.2d at 313 n.2. As this Court noted in *Bergman*, “The involvement of an independent third party lender was critical to the result [in *Gilday*] because there is no question that a lender such as a bank intends to enforce repayment, truly placing the shareholder’s money at risk.” 174 F.3d at 933.

2. As these precedents show, transactions are not always in substance what they appear to be, especially when they are executed solely to garner a tax benefit. Indeed, sometimes elaborate charades or paper shuffles are created for the appearance that something of consequence has occurred for tax purposes when, in fact, nothing has taken place that puts the parties on a genuinely different footing from where they stood just before the transaction was effected. In such circumstances, the courts have recognized that, in order to protect the fisc, the Commissioner has the power to disregard the form of transaction used by the taxpayer, where, for instance, that form is a sham or unreal or where the transaction serves no purpose other than to avoid taxation. 10/

10/ On the other hand, where there is more than one way to carry out a transaction, the tax consequences of the various alternatives often differ, and the Commissioner can hold the taxpayer to the tax consequences of his chosen form
(continued...)

The watershed case is *Gregory v. Helvering*, 293 U.S. 465 (1935). The taxpayer there, in hopes of avoiding ordinary income (dividend) treatment on the distribution to her from a corporation she owned of stock that corporation in turn held, attempted to clothe her transaction in the guise of a tax-free corporate reorganization. To that end, she caused her corporation to establish a dummy corporation, all of whose stock was issued to her in a supposed tax-free reorganization. The first corporation then transferred the stock it had held to the dummy, which dissolved three days later, distributing the stock to the taxpayer, resulting in a capital gain. *Id.* at 467. The Supreme Court held that the stock distribution was taxable as a dividend, as if it had been distributed directly to her from the first corporation and the “reorganization” and subsequent liquidation had never taken place. The Court acknowledged that the taxpayer’s tax avoidance motive was not dispositive, but it held that the transaction itself had to be genuine:

10/(...continued)

of transaction, because “[t]he choice of disregarding a deliberately chosen arrangement for conducting business affairs does not lie with the creator of the plan.” *Gray v. Powell*, 314 U.S. 402, 414 (1941). It is well established that, “while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not.” *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148 (1974).

The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

293 U.S. at 469 (citations omitted). The Court then held that the reorganization was “nothing more than a contrivance,” a “conveyance masquerading as a corporate reorganization, and nothing else.” 293 U.S. at 469-70.

In numerous other cases, the Supreme Court and this Court have held that a tax benefit will not be recognized unless it is based on a genuine transaction having economic substance. These cases include *Knetsch v. United States*, 364 U.S. 361, 364-65 (1960), where a formal annuity contract was found to be in substance a device for obtaining inflated interest deductions, *Higgins v. Smith*, 308 U.S. 473, 475-76 (1940), where the Court held that the taxpayer could not generate a loss by selling stock to corporation controlled by himself, in a series of transactions that “do not vary control or change the flow of economic benefits.” And among this Court’s decisions on point, besides *Bergman*, 174 F.3d at 931 n.6 (citing *Knetsch*), are *Sather v. Commissioner*, 251 F.3d 1168, 1174-1175 (8th Cir. 2001), where this Court refused to immunize from gift tax reciprocal cross-gifts designed to evade the limitation on the present interest exclusion, and *Shoenberg*, 77 F.2d at 449, where this Court refused to accord loss treatment to a wash sale of stock,

even though the repurchase was made just after the 30-day period for automatic disallowance under § 1091.

A corollary to the “substance over form” doctrine is the “step transaction” doctrine: a series of interrelated steps will be treated as a single whole, with purely formal intermediate steps disregarded. For example, in *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), a corporation negotiated the sale of its sole asset, a building, with a buyer, but before consummating the transaction, it distributed the building to its shareholders as a liquidating dividend; the shareholders then sold the building to the buyer. The Court held that the intermediate step—the transfer to the shareholders—was a “mere formalism” interposed to prevent the sale from being taxed to the corporation, and would be disregarded. 324 U.S. at 333-34. *See also Commissioner v. Clark*, 489 U.S. 726, 737-40 (1989); *Smith v. Commissioner*, 537 F.2d 972, 975-976 (8th Cir. 1976) (refusing to accord “like kind” nonrecognition treatment to exchange of property involving parcel that had first been bought by the taxpayer and then sold to his brother before being reconveyed to taxpayer as part of the exchange); *Haag v. Commissioner*, 334 F.2d 351, 354-355 (8th Cir. 1964) (transaction between taxpayer and his company was not, viewed in its totality, a genuine, arm’s-length sale, and taxpayer’s gain was therefore taxable as ordinary income).

Significantly, these principles have often been applied to set aside the tax benefits of creating supposed indebtedness where the circularity of payments do no more than create the illusion of indebtedness. *See, e.g., Erhard v. Commissioner*, 46 F.3d 1470, 1477-1478 (9th Cir. 1995); *Drobny v. Commissioner*, 86 T.C. 1326, 1346 (1986); *Karme v. Commissioner*, 76 T.C. 1163, 1186-1187 (1980), *aff'd*, 673 F.2d 1062 (9th Cir. 1982); *Santulli v. Commissioner*, 70 T.C.M. (CCH) 801, 809 (1995); *see also Pike v. Commissioner*, 78 T.C. 822 (1982), *aff'd without published opinion*, 732 F.2d 164 (9th Cir. 1984); *Bergman*, 174 F.3d at 934 (material issues of fact regarding the genuineness of circular loans precluded the District Court's grant of summary judgment to the taxpayer).

3. A common thread runs through the cases requiring that there be an “actual economic outlay” to support basis, that the substance of a transaction match the form to be considered dispositive for tax purposes and that steps taken solely to create the appearance that something of moment has happened for tax purposes will be disregarded. Taken together, their teaching is that an obligation running to a shareholder must be genuine, representing an actual out-of-pocket investment in the corporation, and result from transactions that are in substance real in order to give rise to basis in the corporation for purposes of § 1366(d)(1).

In this case, the Tax Court, applying these fundamental principles to the facts presented, concluded that the purported loan transactions among Dart, taxpayer, HL and HS had “no net economic effect.” (App. 21a.) From the indisputable premise that “the loan proceeds originated with Dart and ended with Dart” (*id.*), reasoned the court, there followed the inescapable conclusion that “Mr. Oren was nothing more than a ‘conduit through which Dart funneled money to HL and HS and back to itself’” (App. 28a). At the end of the day – and in 1993 and 1994 the entire cycle of loans occurred in the space of a day (*see* A. 224) – taxpayer was not left poorer in any material sense. *Bergman*, 174 F.3d at 931-932 & n.6; *Perry*, 54 T.C. at 1296. As we shall show, that conclusion clearly is correct and should be affirmed.

B. *The Tax Court correctly found that the circular loan arrangements did not result in an actual economic outlay because they lacked economic substance*

As the Tax Court recognized (App. 25a), the case law places “‘a heavy burden on shareholders who seek to rearrange the indebtedness of related closely held S corporations.’” *Bergman*, 174 F.3d at 933 (quoting *Bhatia v. Commissioner*, 72 T.C.M. (CCH) 696, 700 (1996)); *see also Hitchins v. Commissioner*, 103 T.C. 711, 715 (1994). Such a burden cannot be surmounted, we submit, by a taxpayer who seeks to manufacture indebtedness *ab nihilo* by

cycling funds through himself and his S corporations in order to generate basis where no real investment has been made.

When the transactions here in issue are scrutinized, it is manifest that each leg of the tripartite lending series was inextricably intertwined with the other two legs thereof. All entities participating were under taxpayer's control: he owned all of the stock of HL and HS, all of the Dart's voting stock and a majority of all of its stock to boot. (A. 22, 27, 29.) Taxpayer himself signed all of the notes except the one from HS back to Dart in 1995. (A. 222.) Although the parties to the transactions did execute separate loan instruments and pass around checks, these activities served only as a more elaborate subterfuge than the offsetting bookkeeping entries that failed to generate basis in such cases as *Griffith* and *Burnstein*. The timing of the execution of the notes was simultaneous or very nearly so. In 1993 and 1994, the notes on each of the three legs of the series were executed the same day, and in 1995, only 13 days elapsed between the date of taxpayer's note to Dart and the notes of HS to taxpayer and Dart to HS. (A. 212-223.)

So as to create obligations that were exactly or virtually offsetting, the amounts of the notes were identical as between the parties in 1993 and 1994 and differed only marginally in 1995 (\$100,000 in two instances out of \$4-4.5 million,

representing taxpayer's interjection of his personal funds). (A. 224.) The notes' terms were identical, providing for the same interest rates and repayment terms. (A. 212-223.) In short, their net effect was to cancel one another's obligations.

The transfers of both the loan proceeds and the annual interest payments occurred simultaneously or nearly so, and two out of three in each series were made through First Bank. (A. 224.) To be sure, there were variations in the sequence of transfers. For example, in 1993, the check from HL to Dart was written the day before the checks from Dart to taxpayer and taxpayer to HL, and that in 1994, the checks from HL to Dart and from taxpayer to HL were written two days before Dart wired the funds to taxpayer. (A. 224.) But these matters are inconsequential, because each series of payments soon came full circle. If anything, the fact that a transfer of proceeds was out of sync with the corresponding notes would tend to cast doubt upon the bona fides of both. The critical fact remains that the advances did not come to rest with the parties to which they were routed, but perfunctorily touched the bases, shifting back and forth in accordance with the ostensible obligations. The funds may have flowed, but they were soon swept back from whence they came.

Taxpayer's insistence that "each of the loans was bona fide" (Br. 37-38) is unavailing. The circular transactions were not genuine. When all was said and

done, the elaborate series of notes and flurry of transfers was no more indicative of a true change in the parties' relative economic positions than the book entries and paper shufflings that failed to generate basis in *Griffith*, *Burnstein*, *Wilson*, *Shebester*, *Hitchins*, *Underwood* and *Bergman*. As the Tax Court aptly put it, "the loans to HL and HS simply entered the 'front door', immediately exited through the 'back door', and were returned to Dart." (App. 21a.) Despite these machinations, the parties' relative economic positions did not changed at all. They simply went through the motions to derive a tax benefit. When a transaction is "nothing more than a contrivance," it is has no effect for tax purposes. *Gregory*, 293 U.S. at 269. As this Court pointed out in *Bergman* (citing *Knetsch*), "Loan transactions, like all transactions, must have independent economic substance to confer tax benefits on the parties." 174 F.3d at 931 n.6. The Tax Court therefore was correct in invoking the sham transaction doctrine, rather than respect taxpayer's illusory obligations.

Had the arrangement entailed an actual net outlay of funds by each party, moreover, it would have made no business sense for Dart to participate at all, given taxpayer's testimony that Dart lacked the funds to finance its loans to him without resorting to its line of credit at First Bank and faced cash flow problems that forced

it to borrow back the same funds from HL and HS. (A. 92-93, 118.) Nor were any funds advanced to HL and HS retained for use in their businesses.

In addition, the terms of the promissory notes could hardly be regarded as consistent with similar transactions between unrelated parties. All taxpayer could say on the subject was that he did not know whether the Dart Companies had ever been offered similar terms. (A. 116.) The loans at issue were for millions of dollars, and yet they were wholly unsecured. The provision for repayment upon demand *plus* 375 days seems highly generous, to say the least, but of course it made no practical difference to any of the parties when – or if – repayment might take place, since each was given the funds he or it lent on to the next, and each could have made an offsetting demand on another if ever faced with a demand. And one person – taxpayer – was in a position to control when and whether each party's demand for repayment on another would be made.

Further, the circumstances surrounding the repayments of principal that in fact took place in 1996 confirm the illusory nature of taxpayer's purported "investment." There is no evidence that the parties complied with the repayment terms by making formal demand, and hence there is no way to know whether they took advantage of the 375-day grace period for repayment. In the case of HS, repayment occurred less than one year after two of the notes were signed and all of

the proceeds were paid. (A. 222-223, 225-226.) Taxpayer conceded that the repayments were motivated solely by the threatened loss of the loans' tax benefits, rather than by investment considerations touching his personal financial interests or the Dart Companies' business needs. (A. 128.)

Repayment of *all* the loans was made on a single day, December 19, 1996, ensuring once and for all that the parties' economic positions were unchanged. Dispensing with the formality (or pretense) of a personal check in respect of his own repayments, taxpayer simply endorsed over to Dart the checks he received from HL and HS. (A. 225-226.) Since Dart, HL and HS all were account-holders, the funds taxpayer used for repayment arguably never even left First Bank. (*Id.*)

Not only did the loans by taxpayer involve no actual outlay of his funds, but a number of other facts suggest that they did not represent a direct obligation to him from HL and HS. Taxpayer's personal financial statements do not reflect any such obligations from HL and HS, nor his own purported loan obligations to Dart. (App. 12a.) Similarly, the combined financial statements for the Dart Companies for 1993 and 1994 do not show a debt due from HL to taxpayer, nor from taxpayer on to Dart. (*Id.*) Taxpayer's participation in the circular loan arrangement was simply ignored on all sides until 1995, and for that year the Dart Companies' combined balance sheet shows only the net personal investment of \$200,000 that

taxpayer made and the Commissioner allowed. (*Id.*; A. 210.) As the Tax Court noted (App. 13a n.7), even if the Dart Companies' offsets with one another are appropriate to reflect "the financial position and operating results of a single business enterprise," the absence of the loans running to or from taxpayer personally cannot be explained by the same rationale.

C. *Taxpayer's contentions lack merit*

1. Taxpayer's reliance on the *District Court's* analysis in *Bergman* (Br. 24-30; *see* App. 40a-49a) is woefully misplaced. In reversing the judgment of that court on the very issue here before the Court – whether a shareholder's "loan" to an S corporation can give rise to basis absent an actual economic outlay by the shareholder – this Court removed all precedential value from that court's resolution of that issue. *See Universal Underwriters Ins. Co. v. McMahon Chevrolet-Oldsmobile, Inc.*, 866 F.2d 1060, 1063 (8th Cir. 1989). It is preposterous to describe the District Court's opinion in *Bergman* as nonetheless "highly persuasive" (Br. 25-26 n. 12), when that court had reasoned that "the economic outlay doctrine has no application to this action" (App. 47a), and this Court said exactly the opposite: "the economic outlay doctrine does not apply only to loan guarantees" *Bergman*, 174 F.3d at 933.

To say that the remand in *Bergman* did not undermine the District Court's analysis because "unresolved factual issues . . . made the case unsuitable for disposition by summary judgment" (Br. 25 n.12) misses the point that a material factual question as to whether the disputed loans in *Bergman* were "genuine" only arose material under *this* Court's contrary analysis of the applicable law. *See id.* at 934. As the Court pointed out in *Bergman*, 174 F.3d at 931 n.6, "the position that there was no economic outlay and . . . that the [disputed] transactions did not have any economic substance were not distinct theories, . . . but rather the same argument presented at different levels of generality." Under *this* Court's reasoning in *Bergman*, the foundations of taxpayer's argument in the present case – that "the source of the shareholder funds is irrelevant under section 1366," that "[t]he form of the taxpayer's transaction under section 1366 must be respected," and that "[t]he government must point to some evidence that the loans from the related entity are not in reality loans" (Br. 26) – have simply fallen away.

2. As the Tax Court recognized (App. 24a-25a), *Gilday*, despite taxpayer's reliance, is readily distinguishable. The fact that the unrelated third party – the bank – could be counted on to enforce its loan when due weighed heavily in the Tax Court's conclusion in *Gilday* that the restructuring was a genuine loan transaction that created genuine indebtedness and increased the taxpayers' basis.

43 T.C.M. (CCH) at 1297; *see also Bergman*, 174 F.3d at 933; *Underwood*, 535 F.2d at 933 (discussing *Gilday*). The loans here did not emanate from an independent bank setting arm's length terms but involved, instead, the controlling shareholder of the three companies participating in the circular loan arrangement.

Similarly misplaced is taxpayer's reliance (Br. 36-37) on *dictum* in *Hitchins*. Although the court there rejected an attempt at restructuring, it went on to suggest, in *dictum*, that the attempt "might well have succeeded had [the taxpayer] adopted another form of the transaction in question, e.g., by way of a novation," either by releasing the sister corporation from liability and obtaining a replacement note from the S corporation or, alternatively, by the taxpayer's lending the S corporation the money to repay its own obligation to the sister corporation so that the sister corporation might repay the taxpayer, resulting in a direct obligation running from the S corporation to the taxpayer in either event. 103 T.C. at 718-719.

We disagree with the suggestion that the shuffling of obligations among related parties could so easily give rise to basis. To be sure, this Court observed in *Bergman* that "[t]he existence of a close relationship between the parties to the transaction 'is not necessarily fatal if other elements are present which clearly establish the bona fides of the transactions and their economic impact.'" 174 F.3d at 93 (quoting *Bhatia*, 72 T.C.M. (CCH) at 700). At the same time, this Court

observed that the presence of an independent third party in *Gilday* (the bank) was critical to the result in that case. 174 F.3d at 933; *see also Underwood*, 535 F.2d at 313 n.2. Furthermore, the Tax Court in *Hitchins* made it clear that only a complete substitution of the taxpayer for the original lender, making the S corporation “solely and directly indebted” to the taxpayer, would accomplish the intended increase in basis. The court, in other words, was contemplating a change in economic position that would leave the taxpayer poorer in a material sense. Nowhere in *Hitchins* did the Tax Court suggest that a circular loan arrangement that *fails* to alter the parties’ financial or economic positions can generate an increase in shareholder basis in an S corporation. Here, too, the Tax Court correctly avoided such a result. 11/

11/ *Culnen v. Commissioner*, 79 T.C.M. (CCH) 1933 (2000), *rev’d in part and remanded on other grounds*, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,200 (3d Cir. 2002), cited by taxpayer (Br. 30), is readily distinguishable. There, the Tax Court was satisfied that the taxpayer was genuinely out-of-pocket with respect to advances to a controlled S corporation, despite his having “borrowed” such funds from another controlled corporation that he treated as an “incorporated pocketbook.” The court credited the testimony of the accountant who had represented the taxpayer for 20 years that the funds so withdrawn, albeit charged to a loan account, consisted of amounts previously taxed to the taxpayer that he felt he were rightfully his and that, in addition, the taxpayer from time to time reduced any balance on the loan account by making contributions to capital. 79 T.C.M. (CCH) at 1937. Taxpayer failed to establish that his situation is comparable.

(continued...)

3. Taxpayer also seeks to distinguish *Bergman* (Br. 24), pointing out that here, there was “an actual transfer of cash in exchange for a note.” *Underwood*, he argues (Br. 37), is distinguishable for the same reason. Taxpayer conveniently ignores, however, that the flow of cash here was circular, and that circular transactions have repeatedly been found to lack substance in such cases as *Erhard*, *Drobny*, *Karme*, *Santulli* and *Pike*. Cases such as *Court Holding Co.*, *Clark*, *Smith* and *Haag* teach that, to be respected, the series of transactions, taken as an integrated whole, must leave the parties in different economic positions than they previously occupied, and taxpayer cannot make that claim here. After all, “the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.” *Gregory*, 293 U.S. at 469; see *Knetsch*; *Higgins v. Smith*; *Bergman*; *Sather*; *Shoenberg*.

Notably, the circumstances here are even less compelling than those presented in *Bergman* and *Underwood*, as well as *Hitchins*. In all three cases, at

11/(...continued)

Despite taxpayer’s reliance (Br. 18-21), *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), is completely inapposite. The Supreme Court did not purport to address the actual economic outlay doctrine. The threshold question there was whether the *discharge* of indebtedness of an insolvent S corporation was an “item of income” within the meaning of § 1366(a)(1)(A), and the Court had no occasion to consider the parameters of “indebtedness” itself under § 1366(d)(1).

least some party was out of pocket: there, the sibling corporations that had actually made the advances sought to be restructured as debt to shareholders. Here, neither HS nor HL effectively retained funds received from any party. Nor did the fact that, in *Underwood*, as here, interest payments were made on the ostensible debt to the shareholders salvage the validity of the transaction.

4. It is unavailing (Br. 38-42) for taxpayer to point to the parties' formal repayment obligations as cloaking the transactions with authenticity. Taxpayer simply has shown no error in the Tax Court's conclusion that it was "highly improbable" that Dart would have called in its loans to him. (Br. 41; *see* App. 25a-27a.) Taxpayer ignores the fact that a demand by Dart on him would have been tantamount to a demand by himself upon himself, as would a demand by taxpayer upon HL or HS, or by either of them upon Dart. And in emphasizing the value of Dart's receivable from himself, taxpayer ignores the fact that he had corresponding receivables from HL and HS, which in turn held receivables from Dart. Whatever concerns unspecified creditors of Dart could plausibly have harbored "if Dart did not enforce all its rights with respect to that asset" (Br. 41), these offsetting claims created an equilibrium in which it behooved no creditor to go after the next in line. Tellingly, taxpayer concedes (Br. 39) that "the likelihood was not great" that the default scenario he envisions would ever materialize in fact. Taxpayer attempts to

limit that admission to the possibility that a single vehicle accident would exceed HS's ability to pay (*id.*), but the larger record speaks for itself.

5. Taxpayer's emphasis (Br. 27) on the rights of Dart's "minority shareholders" to enforce the loans against him under state law is overblown. Minn. Stat. Ann. § 302A.467 (miscited by taxpayer as § 302A.476) (Br. 27)) authorizes equitable relief in a shareholder suit for violation of the corporation statutes by a corporation, officer or director, while § 302A.751 authorizes equitable relief in lieu of dissolution. Neither circumstance is present here, and, for all the record shows, their likelihood of occurrence is remote. Although taxpayer implies that the active participation of his wife and their three sons in "running the businesses" made it likelier that they would press for repayment of his loans (Br. 27), it is equally plausible, as the Tax Court found (App. 27a), that they would not have acted against his wishes.

II

THE TAX COURT CORRECTLY HELD THAT
TAXPAYER WAS NOT AT RISK UNDER § 465 FOR
BORROWED FUNDS ADVANCED BECAUSE THE
CIRCULARITY OF THE LOAN ARRANGEMENTS
AMOUNTED TO A STOP-LOSS ARRANGEMENT
UNDER § 465(b)(4)

Standard of Review

The Tax Court's determination that taxpayer was not at risk is a matter of law is reviewable *de novo*. *Moser v. Commissioner*, 914 F.2d 1040, 1045 n.11 (8th Cir. 1990). Some of the Tax Court's underlying determinations, however, are findings of fact to be disturbed only for clear error. *See id.* at 1044-1045.

A. *Introduction*

Section 465(a)(1) provides that a taxpayer engaged in most business or income-producing activity, including equipment leasing, the activity engaged in by HL and HS, *see* § 465(c)(1)(C) (App. 30a n.21), may deduct a loss from that activity “only to the extent of the aggregate amount with respect to which the taxpayer is at risk . . . for such activity at the close of the taxable year.” Any loss from an activity that is not allowed as a deduction under § 465 is treated as a deduction allocable to the activity in the next taxable year. IRC § 465(a)(2). Section 465 was enacted in 1976 in response to significant abuses posed by the use

of nonrecourse financing and other risk-limiting devices in tax shelters. *See* S. Rep. No. 94-938 at 45-51 (1976), *reprinted in* 1976-3 C.B. (Vol. 3) 49, 83-89).

Congress contemplated that a taxpayer's amount "at risk" with respect to an activity would generally be the amount he "could actually lose from th[e] activity." H.R. Rep. No. 95-1445 at 67 (1978), *reprinted in* 1978-3 C.B. (Vol. 1) 181, 241. Accordingly, a taxpayer is generally considered "at risk" for an activity to the extent of the cash and the adjusted basis of property contributed to the activity (§ 465(b)(1)(A)), and with respect to amounts borrowed for use in an activity to the extent that he "(A) is personally liable for the repayment of such amounts or (B) has pledged property, other than property used in the activity, as security for the borrowed amount" (§ 465(b)(2)).

Borrowed amounts, however, are not considered to be at risk if they are borrowed from a person who "has an interest (other than an interest as a creditor) in such activity." IRC § 465(b)(3)(A). A taxpayer also is not considered at risk with respect to "amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." IRC §§ 465(b)(3), (b)(4); *see* S. Rep. No. 94-938, *supra*, at 49-50.

As this Court recognized in *Moser*, 914 F.2d at 1048, the legislative history of § 465 "sheds some light" the meaning of the term "other similar arrangements"

as used, but not defined, in § 465(b)(4). *See* S. Rep. No. 94-938, *supra* at 49-50. The Senate Report states that a taxpayer's capital is not at risk "to the extent he is protected against economic loss . . . by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer." S. Rep. No. 94-938, *supra* at 49. The legislative history shows that Congress was concerned "with situations in which taxpayers are effectively immunized from any realistic possibility of suffering an economic loss, even though the underlying transaction was not profitable." *Melvin v. Commissioner*, 88 T.C. 63, 70-71 (1987), *aff'd*, 894 F.2d 1072 (9th Cir. 1990). *Accord*, *Moser*, 914 F.2d at 1048; *American Principals Leasing Corp. v. United States*, 904 F.2d 477, 483 (9th Cir. 1990); 12/ *Larsen v. Commissioner*, 909 F.2d 1360, 1369 (9th Cir. 1990); *Follender v. Commissioner*, 89 T.C. 943, 955 (1987). The purpose is to "prevent a situation where the taxpayer may deduct a loss in excess of his economic investment" (S. Rep. No. 94-938, *supra* at 48), and to limit the taxpayer's deductions to the amount he "could actually lose from the activity" (H.R. Rep. No. 95-1445, *supra* at 67).

12/ In *Moser*, this Court referred to the *American Principals* case as *Baldwin*, after another party to the case.

In light of this purpose, this Court, as well as other courts of appeals, have taken “economic reality as [their] guide” in determining whether there is “any realistic possibility that [the taxpayer] will suffer an economic loss.” *Moser*, 914 F.2d at 1048; *accord*, *American Principals*, 904 F.2d at 483; *Casebeer v. Commissioner*, 909 F.2d 1360, 1369 (9th Cir. 1990); *Waters v. Commissioner*, 978 F.2d 1310, 1316 (2d Cir. 1992); *Young v. Commissioner*, 926 F.2d 1083, 1087 (11th Cir. 1991). A “theoretical possibility that the taxpayer will suffer economic loss is insufficient to avoid the applicability of [§ 465(b)(4)].” *Moser*, 914 F.2d at 1048. In particular, examination of the “worst-case scenario” is “not proper” when determining whether the taxpayer has engaged in a loss-limiting arrangement within the meaning of § 465(b)(4). *Id.* If the unexpected occurs at some future time, and a realistic possibility of loss then develops, then the taxpayer will become at risk and may deduct the losses. *Id.*; *American Principals*, 904 F.2d at 483.

In *Moser*, this Court applied the economic reality test to an equipment leasing arrangement, taking into account the circular nature of the arrangement between the taxpayers, the lender/seller, and the lessor/seller and the mutually offsetting nature of the obligations and the payments thereunder, which effectively immunized the taxpayers from economic loss. 914 F.2d at 1049. The economic reality was that none of the other parties to the tripartite arrangement could obtain enforcement of

the taxpayer's obligation without simultaneously satisfying their obligation to the taxpayer. *Id.* The Court acknowledged that a default by one of the parties could "break the chain of payments," but it reiterated that the "possibility that one of the parties will at some future point become insolvent and/or bankrupt, or decide for whatever reason to suspend payments, is not material under § 465(b)(4) unless and until the time the event happens or a realistic possibility develops that it might." *Id.*

B. *Taxpayer was protected against loss within the meaning of § 465(b)(4)*

In this case, the Tax Court properly followed *Moser*'s teaching in determining that the circular loan arrangements here were loss-limiting arrangements under § 465(b)(4). (See App. 31a, 36a-37a.) The court's determination that taxpayer was protected against loss on his loans to HL and HS was informed by similar considerations to those shaping the court's § 1366 analysis. (See App. 33a-35a.) As in *Moser*, the circularity of the loan arrangement among Dart, Mr. Oren, and HL and HS was crucial. See *Moser*, 914 F.2d at 1044, 1049; *Levien v. Commissioner*, 103 T.C. 120, 127-128 (1994), *aff'd without published opinion*, 77 F.3d 497 (11th Cir. 1996). As was explained at length above, for each sequence of lending transactions, the loan proceeds originated with and returned to Dart. The identical loan terms ensured symmetrical interest payments while avoiding principal

payments throughout the years in issue. In 1996, the loans were satisfied through an exchange of checks drawn on the Dart Companies' accounts at a single bank. From taxpayer's perspective, the repayments were a matter of bookkeeping.

In short, despite taxpayer's hollow insistence (Br. 43) that there was no stop-loss arrangement, the economic reality of the situation was that no party could enforce another's obligation without triggering a demand for payment against itself, and hence no party would or did. *See Moser*, 914 F.2d at 1049-1050; *American Principals*, 904 F.2d at 483. Taxpayer's control by stock ownership and management of Dart, HL, and HS reinforced the circularity of the arrangement by allowing him to control its implementation at every point. *See Levien*, 103 T.C. at 120 (examining party relationships, circularity, nonrecourse borrowing, payment guarantees and offsetting payments and bookkeeping entries in determining economic reality). In this way, taxpayer effectively immunized himself against any realistic possibility of suffering an economic loss in the loan arrangement.

C. *Taxpayer's arguments are unavailing*

In taking out of context (Br. 43-44) the statement in Tech. Adv. Mem. 109286-99 (Sept. 15, 1999) that "no rule exists that holds circular payments to per se constitute 'an other arrangements [sic] for purposes of § 465(b)(4),' taxpayer completely distorts the point of that pronouncement, which apparently relates to

this very case. Far from conceding that circular payments have no place in “other similar arrangements,” as taxpayer implies (Br. 43), the Commissioner finished that sentence by stating that “they are an element to be considered,” and he went on to conclude that the circularity of payments, as well as the other factors discussed above, showed that taxpayer was protected against loss.

Also misconceived is taxpayer’s argument (Br. 44-49) that the circular loan arrangement is not analogous to a sale-leaseback transaction. Taxpayer cites no authority for the proposition, and it is clear that the provisions of § 465 are not so limited. *Lansburgh v. Commissioner*, 92 T.C. 448, 451 (1989); *Peters v. Commissioner*, 77 T.C. 1158, 1164-1165 (1981). As the Ninth Circuit explained in *American Principals*, 904 F.2d at 483, “the purpose of subsection 465(b)(4) is to suspend at risk treatment where a transaction is structured – *by whatever method* – to remove any realistic possibility” of economic loss. (Emphasis added.)

Moser and *American Principals* do not require the Commissioner to “link[] the loan payments to the lease payments” in order to “prove that the loans in this case eliminated any possibility of losses from the leasing activities of HL and HS” (Br. 48-49), quite apart from the fact that it remained *taxpayer’s* burden to prove that he faced a real possibility of economic loss, *see Levien*, 103 T.C. at 126. To the contrary, *Moser* makes clear that it was “the circular nature of the arrangement”

there in issue, rather than the source of the payments involved, that immunized the taxpayers against loss. 914 F.2d at 1049. *Moser* also forecloses taxpayer's attempt (Br. 47) to distinguish *American Principals* from this case on the ground that the partners in *American Principals* lacked the financial ability to satisfy their offsetting obligations. 914 F.2d at 1050. And neither *Moser* nor *American Principals* attaches any particular significance to the fact that, in *American Principals*, no cash changed hands between the partners, even aside from the fact that the flow of funds here was both transitory and circular.

Although taxpayer argues (Br. 49) that he must be considered at risk unless the loans here "removed all risk that HL and HS would become unprofitable," this approach resembles the "worst-case" approach expressly rejected in *Moser*, 904 F.2d at 482-483. Either way, taxpayer has not shown that he faced anything more than a theoretical possibility of economic loss, and that is "insufficient" under *Moser* to avoid the application of § 465(b)(4). *Id.* at 483. Even so, taxpayer's analysis of the business risks facing HL and HS (Br. 49-51) fails to account for the parties' offsetting obligations under the circular loan arrangements, which were unaffected by the surrounding business climate, whether good or bad. Only by positing the worst case – a decline in equipment values or other "business reverses" that "fully wiped out . . . stockholders' equity" in one of the Dart

Companies (Br. 50-51) – can taxpayer posit a scenario where he would face a demand for repayment from Dart without satisfaction of his claim against HL or HS. The *reality* of the situation, however, as taxpayer concedes (Br. 50-51), is that the Dart Companies enjoyed consistent financial success in a highly competitive industry.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH TYPE VOLUME LIMITATION

Pursuant to Rule 32(a)(7)(C) of the Federal Rules of Appellate Procedure and Eighth Circuit Rule 28A(c)-(d), I certify that this brief was prepared with Word Perfect 9, uses Times New Roman 14 point typeface and contains 13,947 words (excluding the table of contents, statement with respect to oral argument and certificates of counsel) and that the computer diskettes provided to the Court and to counsel for the appellant have been scanned for viruses using a commercial virus scanning program, which reports that the diskettes are virus-free.

ANDREA R. TEBBETS
Attorney

STATUTORY ADDENDUM

Internal Revenue Code of 1986 (26 U.S.C.):

SEC. 465. DEDUCTIONS LIMITED TO AMOUNT AT RISK.

(a) *Limitation to amount at risk.*—

(1) *In general.*—In the case of—

(A) an individual, and

(B) a C corporation with respect to which the stock ownership requirement of paragraph (2) of section 542(a) is met,

engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.

(2) *Deduction in succeeding year.*—Any loss from an activity to which this section applies not allowed under this section for the taxable year shall be treated as a deduction allocable to such activity in the first succeeding taxable year.

* * *

(b) *Amounts considered at risk.*—

(1) *In general.*—For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including—

(A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and

(B) amounts borrowed with respect to such activity (as determined under paragraph (2)).

(2) *Borrowed amounts.*—For purposes of this section, a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he—

(A) is personally liable for the repayment of such amounts, or

(B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).

No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1).

(3) *Certain borrowed amounts excluded.*—

(A) *In general.*—Except to the extent provided in regulations, for purposes of paragraph (1)(B), amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who has an interest in such activity or from a related person to a person (other than the taxpayer) having such an interest.

(B) *Exceptions.*—

(i) *Interest as creditor.*—Subparagraph (A) shall not apply to an interest as a creditor in the activity.

(ii) *Interest as shareholder with respect to amounts borrowed by corporation.*—In the case of amounts borrowed by a corporation from a shareholder, subparagraph (A) shall not apply to an interest as a shareholder.

* * *

(4) *Exception.*—Notwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected

against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

(5) *Amounts at risk in subsequent years.*—If in any taxable year the taxpayer has a loss from an activity to which subsection (a) applies, the amount with respect to which a taxpayer is considered to be at risk (within the meaning of subsection (b)) in subsequent taxable years with respect to that activity shall be reduced by that portion of the loss which (after the application of subsection (a)) is allowable as a deduction.

* * *

(c) *Activities to which section applies.*—

(1) *Types of activities.*—This section applies to any taxpayer engaged in the activity of—

(A) holding, producing, or distributing motion picture films or video tapes,

(B) farming (as defined in section 464(e)),

(C) leasing any section 1245 property (as defined in section 1245(a)(3)),

(D) exploring for, or exploiting, oil and gas resources or

(E) exploring for, or exploiting, geothermal deposits (as defined in section 613(e)(2))

as a trade or business or for the production of income.

* * *

(3) *Extension to other activities.*—

(A) *In general.*—In the case of taxable years beginning after December 31, 1978, this section also applies to each activity—

(i) engaged in by the taxpayer in carrying on a trade or business or for the production of income, and

(ii) which is not described in paragraph (1).

* * *

SEC. 1366. PASS-THRU OF ITEMS TO SHAREHOLDERS.

(a) *Determination of shareholder's tax liability.*—

(1) *In general.*—In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year),

there shall be taken into account the shareholder's pro rata share of the corporation's—

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

* * *

(d) *Special rules for losses and deductions.*—

(1) *Cannot exceed shareholder's basis in stock and debt.*—The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) *Indefinite carryover of disallowed losses and deductions.*—Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

* * *

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on counsel for the appellants on this 23d day of May, 2003, by sending two paper copies thereof, and an electronic copy on diskette, in an envelope, properly addressed to him as follows:

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